برنامج الأغذية العالمي

Programme Alimentaire Mondial

World Food Programme

Programa Mundial de Alimentos

Executive Board
Third Regular Session

Rome, 21-25 October 2002

FINANCIAL AND BUDGETARY MATTERS

Agenda item 5

For approval

FINAL REPORT ON THE ANALYSIS OF THE INDIRECT SUPPORT COST (ISC) RATE

Distribution: GENERAL
WFP/EB.3/2002/5-C/1
13 September 2002
ORIGINAL: ENGLISH

Note to the Executive Board

This document is submitted for approval by the Executive Board.

The Secretariat invites members of the Board who may have questions of a technical nature with regard to this document to contact the WFP staff focal points indicated below, preferably well in advance of the Board's meeting.

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Should you have any questions regarding matters of dispatch of documentation for the Executive Board, please contact the Supervisor, Meeting Servicing and Distribution Unit (tel.: 066513-2328).

Executive Summary

This document sets out the result of the final analysis and review of the indirect support cost (ISC) rate, which was presented to the Board in May 2002 on a preliminary basis. This final analysis includes the results of the seven "next steps" that were undertaken by the Secretariat as required by the Board in May 2002; the conclusions arrived at for each of these steps; the actions to be undertaken by the Secretariat; and the recommendations to the Board arising from these conclusions.

This paper addresses the following questions:

- What is the final outcome of the programme support and administrative (PSA) expenditures in relation to PSA income for the 2000–2001 biennium? What are the reasons for this outcome (or "gap") and what steps should be taken to address it?
- In view of the results of the analysis of the 2000–2001 biennium, what decisions and actions need to be undertaken for the 2002–2003 biennium in the immediate term and for the 2004–2005 biennium in the longer term?
- How does WFP compare with other United Nations and non-governmental organizations (NGOs) with regard to ISC?

The outcome of this comprehensive analysis and review of the ISC rate are as follows:

Structural Imbalances between PSA Income and PSA Expenditure

The structural imbalances between PSA income and PSA expenditures are a result of the present accounting convention for income (cash basis) and expenditures (accrual basis), price and volume fluctuations and other unforeseen PSA expenditures and income. For 2000–2001, the gap amounted to a US$40.1 million shortfall; that is, PSA income was less than PSA expenditure. Part of the interest income generated during the biennium was therefore used to fund this shortfall.

The gap caused by the accounting convention practice can be addressed by simply changing the accounting policy for income. The Executive Director has decided to adopt this policy change for the 2002–2003 biennium in order to do away with this imbalance and to achieve a proper matching of income and expenditure.

The elimination of accounting convention differences for the 2000–2001 biennium would have reduced the overall PSA gap to zero for the period. Notwithstanding this, there were still major PSA income/expenditure compensating differences that netted to zero in 2000–2001. The fluctuations in prices of direct costs reduced ISC income by US$24 million, while an increase in the level of operations increased ISC income by US$61 million. These, combined with the increase in other income for PSA of US$5 million, exactly matched the US$42 million extra PSA expenditure incurred in the biennium.

It is suggested that such PSA gaps should be accounted for using an **equalization account** to record actual gaps and provide the Board with sufficient information to address them.

Such an equalization account will show, in a transparent way, the gap at the end of each year or biennium and why it has arisen. If the gap is a surplus, the Board can either decide to refund donors, or use it to fund future PSA expenditures, thereby reducing ISC rates, or reprogramme it for other purposes. If it is a shortfall, the Board can authorize the present practice of using interest income, if the interest income generated is sufficient to cover the shortfall, or decide to change the ISC rate. The Executive Director has decided to establish this equalization account for the 2002–2003 biennium.

Fixed and Variable Components of the PSA and Impact on 2002–2003 and 2004–2005 Biennia

The review of the nature of the PSA expenditure with regard to its fixed and variable components revealed that within a range of 4 million to 7 million metric tons (mt) per biennium, a variation of 75 percent, PSA requirements vary by only 12 percent. This tonnage range covers the levels of activity of

the last six biennia. At the budgeted level of operational activity for 2002–2003 of 5.5 million mt, approximately three quarters of PSA can be considered fixed in nature.

One quarter of PSA costs vary as WFP's operational level changes. Of the US$165.5 million budgeted for Headquarters and regional office PSA in 2002–2003, US$39.2 million is variable. There appears to be a strong case for reclassifying to Direct Support Costs (DSC) those PSA costs that vary with the level of operations and that can be directly linked to the support of an operation. The Executive Director shall set up a system of attributing these costs to projects and allocating the funds for various uses. PSA would then become purely the fixed overhead costs for managing and administering the Programme and supporting its operations, regardless of the tonnage distributed over a given period. The Executive Director recommends that the Board endorse this principle of reclassifying to DSC the variable components of PSA that can be directly linked to an operation.

In addition, the Executive Director intends to revise the remaining budgeted PSA expenditure level for 2003 downwards by 10 percent, and recommends that the Board reduce the ISC rate for 2003 to 7.0 percent.

For the 2004–2005 PSA budget, there will be a complete review of the assumptions and the basis for setting PSA expenditure levels using a zero-based approach to ensure that WFP has been streamlined to the full extent possible as a result of the implementation of a decentralized organizational structure and the installation of WINGS, and to reflect the fact that a large element of PSA is fixed and cannot be set on the sole basis of tonnages delivered.

Comparative Study of WFP and other United Nations Organizations

The paper also presents the outcome of a comparative study of the indirect support costs of WFP and other United Nations organizations. This study indicates that WFP's indirect support costs are lower in relation to its level of direct costs than those of the other United Nations organizations studied. Even with these United Nations organizations, however, a straightforward comparison is difficult to achieve because of differences in mandates, strategies, modalities for implementation of programmes, outputs and cost classifications.

The Secretariat has begun the comparative study with NGOs and has included the workplan for the completion of the study in this paper.

Comments of the External Audit

As requested by the Board, the final draft of this paper and its annexes was also presented to the External Auditor, whose preliminary comments and suggestions were incorporated in this final paper. A formal report from the External Auditor setting out comments on all financial documents will be made available in early September.

Resources and Long-Term Financing Policy Review

This review of ISC has also revealed aspects of the Resources and Long Term Financing (R&LTF) policies that need to be included in the upcoming review. These are as follows:

- Review of country office funding. The allocation of PSA to country offices should be closely reviewed, particularly in those countries where WFP decides to continue operating but may not have the capacity to absorb the level of operation needed to generate sufficient amounts of DSC.
- Government counterpart cash contributions (GCCC). The use of the GCCC as an additional funding source for ISC income, particularly in defraying costs in country offices, is also an area that needs to be looked at—including the feasibility of implementing the provisions of the Financial Regulations providing for the collection of GCCC.
- PSA results measurement framework. The possibility of establishing a results measurement framework for PSA funded activities should be examined.

Draft Decision

The Executive Director recommends that the Board:

a) **take note** of this final ISC review paper and its Annexes, including the comparative study of United Nations organizations, which represent a comprehensive analysis of the Programme's ISC;

b) **take note** of the US$40.1 million shortfall in the funding of the 2000–2001 PSA actual expenditures and **approve** the use of interest income from the General Fund to fund this shortfall;

c) **take note** of the change to the accounting policy by the Executive Director which will recognize income on an accrual basis with retroactive effect from 1 January 2002;

d) **take note** of the establishment by the Executive Director of a PSA Equalization account to record any gaps between actual PSA income and PSA expenditures and decide how to address these gaps in future, including continuation of the practice of using interest income for any shortfalls;

e) **approve** the reclassification of those PSA expenditures that are variable in nature (support costs that vary with volume changes) and that can be directly linked to an operation to make the PSA more fixed in nature (that is, to represent costs that do not vary with volume changes); the Executive Director shall set up a system of attributing these costs to projects and allocating the funds for various uses;

f) **take note** of the decision of the Executive Director to revise the remaining PSA budget downwards by 10 percent from 1 January 2003;

g) **confirm** the ISC rate of 7.8 percent for 2002;

h) **approve** the reduction of the ISC rate to 7.0 percent for 2003;

i) **look forward to** the submission by the Executive Director of the 2004–2005 PSA budget prepared using a zero based approach with a view to setting an appropriate level of PSA; and

j) **consider** the following matters in the review of WFP's R&LTF policies:

   (i) country office PSA funding;

   (ii) the collection, recording and accounting of GCCC; and

   (iii) result-measurement frameworks for PSA funded activities.

SECTION 1: INTRODUCTION AND PURPOSE

1. The purpose of this paper is to conclude the analysis of the ISC rate for 2000–2001 initiated in the Preliminary Review of the ISC Rate paper presented to the Board in May 2002. It will outline the results of the recent analyses undertaken by the Secretariat to address the "next steps" approved by the Board with a view to establishing an appropriate ISC rate. These are presented as follows:

- **Section 2: 2000–2001 Actual PSA Income and Expenditure Analysis** identifies and analyses the gap between PSA income and PSA expenditure based on the audited financial statements.
- **Section 3: Structural Imbalances of ISC Income** reviews the impact of accounting conventions and direct cost differences on funding PSA expenditure.
- **Section 4: Nature of PSA Expenditure** analyses the fixed and variable elements of PSA costs.
- **Section 5: Final Review of Single ISC Rate** includes a detailed analysis of the PSA gap and its implications on the ISC rate.
- **Section 6: Management of PSA Gaps** outlines the options available for managing PSA gaps.
- **Section 7: Other Funding Options for PSA** reviews and analyses other funding options for PSA, including those options presented by the working group in 1998.
- **Section 8: Appropriate Level of PSA** discusses how an appropriate level of PSA can be defined and established.
- **Section 9: Comparative Study of United Nations and Non-Governmental Organizations** presents the outcome of a comparative study of United Nations organizations' indirect support costs.
- **Section 10: General Conclusions and Recommendations** presents conclusions from the study and makes recommendations.

2. This paper is organized on the basis of the above steps and the Annotated Outline circulated to Board Members in June 2002. The format and sequence have been revised to cover all comments received as a result of the circulation of the Annotated Outline and address all issues in a logical and comprehensive manner.

3. In order to do this, and to streamline the presentation, the detailed analyses and outcomes are presented as annexes to the paper:

- **Annex I:** Background and Methodology;
- **Annex II:** PAS Gap Analysis ;
- **Annex III:** Accounting Conventions ;
- **Annex IV:** Theoretical Analysis of the Impact of Direct Cost Price and Volume Changes on ISC Income;
- **Annex V:** PSA Cost Sensitivity Analysis;
- **Annex VI:** Working Group Funding Options;
- **Annex VII:** Comparative Study of Indirect Support Costs in WFP and Other United Nations Organizations; and
- **Annex VIII:** Comparative Study–Terms of Reference.

SECTION 2: 2000–2001 ACTUAL PSA INCOME AND EXPENDITURE ANALYSIS

A. Explanation of Terms

4. For the purposes of this study, the following definitions are used:

- **PSA costs.** The PSA expenditure for a given period. These can be either:
  - ◊ **PSA budgeted expenditure** (or PSA budget): projected or estimated PSA expenditure for the period; or
  - ◊ **PSA actual expenditure** (or PSA expenditure): actual or realized PSA expenditure for the period.

  PSA costs are currently grouped into the following categories:
  - ◊ **programme support—**costs that arise from the development, formulation, delivery and evaluation of programmes and that cannot be directly linked to the implementation of any specific project; and
  - ◊ **management and administration—**costs arising from the maintenance of the identity, direction and well-being of the organization.
- **PSA income.** The PSA income for a given period. This is made up of:
  - ◊ **ISC income**—the amount of income recovered from contributions during the period through the application of the ISC recovery rate; and
  - ◊ **other income for PSA—**all other sources of funding for PSA. At present this includes GCCC and savings on the cancellations of prior period obligations.
- **PSA gap.** For a given period, this is the difference between PSA income and PSA expenditure. The PSA gap can be a shortfall (where PSA expenditure exceeds PSA income) or a surplus (where PSA income exceeds PSA expenditure).
- **ISC rate.** The percentage applied to contributions to recover ISC income in order to fund PSA expenditure. This percentage is currently 7.8 percent for multilateral and directed multilateral contributions. Variable rates ranging from 3 percent to 7.8 percent are applied for bilaterals and trust fund contributions.
- **Interest income.** All interest earned on the cash balances of multilateral and directed multilateral contributions.
- **Direct costs.** This term is used to refer to the cost of all the inputs that are directly identifiable to the implementation of projects and programmes: Direct Operational Costs (DOC) and DSC.
- **Programme costs.** This term is used by the other United Nations organizations referred to in this study for the cost of direct project and programme inputs.

B. PSA Gap—Causes

5. Any review of the ISC rate (the primary means of funding PSA expenditure) must start with an examination of the PSA gap, that is the difference between PSA income and PSA expenditure.

6. On the basis of the audited financial statements for the 2000–2001 biennium, there was a PSA gap—a shortfall—of US$40.1 million (see Table 1). This PSA shortfall was estimated in May to be US$41.9 million, based on the unaudited accounts.

7. This shortfall signifies that PSA income was not sufficient to fund PSA expenditure for the biennium.

TABLE 1: GAP BETWEEN PSA INCOME AND EXPENDITURES FOR 2000–2001 (US$ million)

ISC income		188.5
GCCC	3.0	
Savings on cancellations of prior period obligations	4.3	
Total income from other sources		7.3
Total PSA income		**195.8**
PSA actual expenditure		235.9
PSA gap (shortfall)		**40.1**

Note: The PSA expenditure figure for 2000–2001 is composed of US$229.6 million recorded in the financial statements under PSA and US$6.3 million PSA expenditure transferred to the Financial Management Improvement Programme (FMIP) special account.

8. In the preliminary review paper, the reasons contributing to this PSA gap were discussed. It highlighted several structural imbalances, including the use of differing accounting conventions and the impact of changing direct input prices and changing volume, which give rise to such gaps.

9. This final paper further analyses this PSA gap and disaggregates the impact of each of these variables by comparing the 2000–2001 original PSA budget figures to the corresponding audited financial statement figures.

10. Using this methodology, the original PSA budget figures are used as a base and the variances from this base are analysed, as outlined in Table 2 for the PSA gap of 2000-2001.

TABLE 2: GAP ANALYSIS FOR 2000–2001 (US$ million)

	2000–2001
PSA shortfall per financial statements	**–40.1**
A. Accounting convention differences Income difference due to accounting conventions (cash versus accrual methods)	40.1
PSA gap restated using accrual concept for income recognition	**0.0**
B. Price difference ISC income not realized due to lower direct input prices	24.2
C. Volume difference Additional ISC income due to increase in volume	–60.7
D. PSA other income difference Additional other income realized	–5.3
E. Difference due to increased PSA expenditure Additional PSA expenditure: budgeted and incurred	41.9
Rounding difference	–0.1
Total	**0.0**

Note: The detailed calculation for this is attached in Annex II.

⇨ *Structural Imbalances and Unforeseen Differences*

11. This analysis outlines the differences, which can be categorized as follows:

a) **Structural imbalances of ISC income**, including differences due to:

i) accounting conventions;

ii) ISC income impacted by direct cost price differences; and

iii) ISC income impacted by direct cost volume differences.

b) **Unforeseen differences** in other income for PSA and PSA expenditure.

The unforeseen differences in other income for PSA arise because of:

i) GCCC: although an amount of US$2 million was included in the PSA budget document, the actual amount received was US$3 million. This difference arises because of the difficulty in predicting these amounts; and

ii) cancellations of prior-period obligations yielded savings of US$4.3 million during the biennium. No amount was included in the PSA budget document because these amounts, by their nature, are unpredictable.

The unforeseen increase in expenditure was a result of the higher level of operations, which were more than 10 percent above the budgeted level, on the basis of which the PSA budget was increased.

12. From a budgetary and planning perspective, the structural imbalances of ISC income create the greatest difficulties and are consequently examined in more detail in Section 3.

Conclusion 1

PSA gap can be attributed to the following factors:

a) **structural imbalances of ISC income,** including differences due to:

- accounting conventions;
- ISC income impacted by direct cost price differences; and
- ISC income impacted by direct cost volume differences; and

b) **unforeseen differences** in other income for PSA and PSA expenditure.

C. Recommendations

13. It is recommended that the Board take note of the US$40.1 million PSA shortfall for 2000–2001 and approve the use of interest income to fund this shortfall.

SECTION 3: STRUCTURAL IMBALANCES OF ISC INCOME

A. Structural Imbalances—Accounting Conventions

⇨ *Introduction*

14. The present accounting conventions have been identified as one of the causes of the PSA gap. The accounting convention difference highlighted in Table 2 arises because ISC income is not calculated on a consistent basis:

a) In the PSA budget document, ISC income is calculated by applying the ISC rate to the budgeted direct costs, after allowing for anticipated other income for PSA.

b) In the financial statements, ISC income is recognized on the basis of cash receipts, that is the actual receipt of the ISC component from the donor.

15. This inconsistency arises because income in the financial statements is recognized on a different basis (cash) from expenditure (accrual), creating a mismatch between income and expenditure in a given financial period.

16. This mismatch is contrary to the matching principle of accounting which "involves the simultaneous or combined recognition of revenues and expenses that result directly and jointly from the same transaction or other events".

17. The recognition of ISC income on a cash basis also introduces an uncertainty into the ISC planning process, that is, the timing of ISC receipts. This creates difficulties in forecasting ISC income and ensuring sufficient funding for PSA expenditure.

⇨ *Accounting Policy on Income Recognition*

18. Changing the accounting policy to recognize income on an accrual basis—at the time at which it is earned, that is, matching as closely as possible the corresponding expenditure—would make it more consistent with the policy on expenditure recognition and would achieve a closer matching of income and expenditure. It would also reduce the uncertainty in the ISC planning process, because ISC income would no longer be impacted by the timing of cash receipts. Annex III outlines this in more detail.

19. This change of accounting policy, if it had been applied in 2000–2001, would give rise to the following:

TABLE 3: INCOME RECOGNITION: CASH AND ACCRUAL BASIS, 2000–2001 (US$ million)

	2000–2001
ISC income—accrual basis	255.1
ISC income—cash basis	188.5
ISC income recognition difference (increase)	**66.6**

20. The increased ISC income recognized as a result of the application of this policy (US$66.6 million) is higher than the accounting convention difference highlighted in Table 2 (US$40.1 million). This arises because, under the revised policy, income is recognized earlier than the corresponding expenditures for cumulative allotment expenditure, where there is no direct link to individual contributions. To recognize income when these expenditures are recognized would be impractical. If all income were

recognized at the same time as expenditure, it would totally remove the accounting convention difference in Table 2.

Conclusion 2

Changing the accounting policy, effective from 1 January 2002, results in a closer but not exact matching of income and expenditure. It also minimizes the structural imbalance between PSA income and PSA expenditures caused by accounting convention differences. This isolates the structural imbalances caused by the unpredictability of direct costs.

B. Structural Imbalances—Changes in Direct Input Prices

⇨ *Introduction*

21. ISC recoveries from donor contributions are based on a percentage of the direct costs of each contribution. Any changes to direct costs will therefore have a corresponding impact on ISC income, even if the ISC rate remains the same.

22. Direct costs, and consequently ISC income, can change as a result of either direct cost price differences or direct cost volume differences. The theoretical impact on ISC income of changes to either of these elements is detailed in Annex IV.

⇨ *Direct Cost Price Differences*

23. As outlined in the preliminary review of ISC, changes to the prices of direct inputs can significantly impact ISC income without necessarily impacting PSA expenditures.

24. The uncertainty involved in accurately forecasting direct input prices up to two years in advance means that ISC income is uncertain. The average direct cost per mt for the biennium, which can be used as a measure of the effect of direct input prices, is affected by many internal and external factors, including:

- the overall WFP food basket;
- the geographical spread and location of projects and programmes;
- the sources of commodities;
- organizational efficiency;
- prevailing market prices and conditions; and
- levels of non-tonnage–related direct expenditures, such as special operations and bilaterals.

25. These factors lead to considerable uncertainty over the actual direct costs for a given biennium and consequently over the corresponding ISC income, which affects PSA income.

C. Structural Imbalances—Changes in Volume

⇨ *Direct Cost Volume Differences*

26. An even bigger determinant of ISC income is the level of operations, which can be measured by the volume of commodities. A level of operations must be estimated and assumed for the preparation of the PSA budget over two years in advance of the final shipment. By the time the biennium is over, the priorities and assumptions on which the

biennial budget was based will almost certainly have changed, given the nature of WFPs operations.

27. Although a mechanism is in place to allow a change to PSA expenditure if the level of operations is different by more than 10 percent of the budgeted level, this does not adequately address two fundamental problems:

a) Changes of up to 10 percent in the level of operations can result in a change in ISC income of up to US$18.9 million. Unless the change *exceeds* 10 percent, there is no mechanism currently in place to change PSA expenditure in such cases. The detailed calculations for this are contained in Annex IV.

b) By the time the actual level of operations becomes reasonably clear, a significant portion of PSA expenditure will already have been incurred. A level of operations that is different from the expected level may give rise to a significant PSA gap, especially given the relatively fixed element of PSA expenditure (see below), because PSA income is influenced by volume to a much greater degree than PSA expenditure.

28. Uncertainty over the level of future operations is caused by the nature of WFP. While every effort can be taken to minimize differences between the budgeted and actual levels of operation, volume differences will almost certainly always occur.

29. Although steps can be taken to adjust PSA expenditure accordingly, the nature of PSA expenditure and the unpredictability of WFP operations mean that there will almost certainly always be a PSA gap caused by volume differences.

Conclusion 3

The unpredictability of ISC income caused by price and volume differences will almost always give rise to a PSA gap, which can be either a shortfall or a surplus.

D. Executive Director's Decision

30. The Executive Director has decided to change the accounting policy on income recognition to an accrual basis, effective from 1 January 2002. This will result in a closer but not exact matching of income and expenditure and will reduce one of the main structural imbalances of ISC income.

SECTION 4: NATURE OF PSA EXPENDITURE

A. Introduction

31. The above discussion has focused on some of the factors that determine ISC, and consequently PSA, income. A thorough examination of the PSA gap, however, demands that PSA expenditure should also be examined.

32. In particular, the "difference due to increased PSA expenditure" in Table 2 highlights the need to look at the relationship between PSA expenditure and the level or volume of operations, that is to examine the nature of PSA in terms of its fixed and variable elements.

B. Fixed and Variable PSA: Over Five Biennia

33. For an overview of the nature of PSA expenditure, the PSA budgets, expenditure and related operational expenditures and tonnages for the five biennia from 1992 to 2001 are shown in Table 4.

TABLE 4: TREND ANALYSIS

	1992–1993	1994–1995	1996–1997	1998–1999	2000–2001
PSA expenditure* (US$ million)	188.8	181.8	226.2	230.8	235.9
Other general fund expenditure (US$ million)	0.0	1.2	17.0	22.4	22.4
Direct expenditure (US$ million)	3 071.0	2 510.0	2 134.6	2 664.3	2 931.3
Total expenditure	**3 259.8**	**2 963.0**	**2 377.8**	**2 917.5**	**3 189.6**
PSA expenditure as percentage of direct expenditure **	6.1	7.2	10.5	8.6	8.0
Tonnage (million mt)	6.977	6.230	4.916	6.182	7.031
PSA expenditure per mt (US$)	27.06	29.18	46.01	37.33	33.55

* The PSA expenditure figure for 2000–2001 is composed of US$229.6 million recorded in the financial statements under PSA and US$6.3 million PSA expenditure that was transferred to the FMIP special account.
** The simple average of these is 8.1 percent.

34. The above data indicates that, after the 1994–1995 biennium, PSA seems to have increased significantly without reference to operational levels. This is demonstrated by the 1994–1995 and 1998–1999 biennia, which have similar tonnage but different PSA expenditure levels. PSA expenditure was US$49 million higher in 1998–1999 than in 1994–1995.

35. The relationship between tonnage or operational level and PSA expenditure will therefore be examined in three stages: 1992–1995 (prior to R&LTF), 1996–1999 (after R&LTF) and 2000–2001 (after revised R&LTF).

⇨ *1992–1995*

36. During this period there was a direct correlation between PSA expenditure and tonnage, both of which decreased, but from a statistical point of view the data is insufficient to draw any conclusion.

⇨ *1996–1999*

37. This direct correlation ends after 1995. The explanation for this can be found in the 1996–1997 PSA budget document, which identifies US$18.6 million of ongoing extra budgetary costs, mainly staff, which were moved to PSA from 1996–1997 onwards. It also outlines the strategic priorities of the 1996–1999 Strategic and Financial Plan. These strategic priorities, in particular increased accountability, modern management systems and stronger advocacy, also gave rise to higher PSA expenditure.

38. To determine any relationship between PSA expenditure and the operational level, adjustments must be made to PSA expenditure to consider these additional costs.

⇨ *2000–2001*

39. Table 4 does not consider the effects of the revised R&LTF policies, which moved 25 percent of country office PSA expenditure from the ISC (PSA) category to the DSC (direct expenditure) category

40. An adjustment should be made to reflect this.

⇨ *Adjusted PSA Expenditure 1996–2001*

41. The following table shows PSA expenditures adjusted for the effects of R&LTF and the additional PSA expenditures incurred from 1996 onwards.

TABLE 5: ADJUSTED TREND ANALYSIS

	1992–1993	1994–1995	1996–1997	1998–1999	2000–2001
			(US$ million)		
PSA expenditure*	188.8	181.8	226.2	230.8	235.9
Adjustments for R&LTF	–21.6	–21.6	–24.8	–25.1	0.0
Adjustments for extra-budgetary expenditure prior to 1996	+18.6	+18.6	0.0	0.0	0.0
Adjustments for costs of strategic priorities (estimated)	+15.0	+15.0	0.0	0.0	0.0
Adjusted PSA expenditure	**200.8**	**193.8**	**201.4**	**205.7**	**235.9**
Adjusted PSA expenditure as percentage of direct expenditure**	6.5	7.7	9.4	7.7	8.0
Tonnage (million mt)	6.977	6.230	4.916	6.182	7.031
Adjusted PSA expenditure per mt (US$)	28.78	31.10	40.96	33.27	33.55

* The PSA expenditure figure for 2000–2001 is composed of US$229.6 million recorded in the financial statements under PSA and US$6.3 million PSA expenditure that was transferred to the FMIP special account.
** The simple average of these is 7.9 percent.

42. Table 5 indicates that for a volume ranging from 4.9 million mt to 7.0 million mt, a 43 percent difference, adjusted PSA expenditure has only varied from US$193.8 million to US$235.9 million, a 21-percent difference.

Conclusion 4

A substantial portion of PSA expenditure is fixed in relation to changes in the operational volume.

C. Fixed and Variable PSA: 2002–2003 PSA Expenditure

⇨ *Sensitivity Analysis*

43. To ascertain the fixed portion of PSA, a sensitivity analysis was conducted to provide additional information for the 2002–2003 biennium on the relationship between changes to operational levels and PSA expenditure requirements. The methodology, results and conclusions of this analysis are attached in Annex V.

44. The sensitivity analysis identified possible changes to the number of staff and levels of non-staff costs required for various ranges of operational activity, referred to as operational bands, for the 2002–2003 biennium:

- up to 4 million mt;
- 4 million to 5 million mt;
- 5 million to 6 million mt; and
- 6 million to 7 million mt.

45. The results of the survey are summarized in Table 6.

TABLE 6: PSA EXPENDITURE REQUIREMENTS FOR TONNAGE BANDS (US$ million)

	Up to 4 million mt	4–5 million mt	5–6 million mt	6–7 million mt
Programme support				
Country offices*	44.3	44.3	44.3	44.3
Regional offices	35.9	40.3	43.4	47.6
Headquarters	17.9	18.4	18.7	19.5
Subtotal	**98.1**	**103.0**	**106.4**	**111.4**
Management	40.2	40.6	41.3	41.7
Administration and statutory requirements	57.2	59.5	62.1	65.2
Total PSA expenditure requirement	**195.5**	**203.1**	**209.8**	**218.3**

*Country office PSA costs were not examined under this exercise, but are considered fixed as they were set centrally using a standard configuration for all country offices.

⇨ *Fixed PSA Costs*

46. Table 6 shows that within a range from 4 million to 7 million mt per biennium, a difference of 75 percent, PSA requirements vary by only 12 percent. This indicates that a considerable portion of PSA expenditure is fixed in terms of changes to the operational level.

47. Further analysis was performed on the above to give a better indication of the likely breakdown of the 2002–2003 PSA budget between fixed and variable elements. By performing linear analysis, a theoretical level of PSA costs at zero tonnage can be estimated. These costs can be considered the fixed element of PSA.

TABLE 7: FIXED AND VARIABLE ELEMENT OF 2002–2003 PSA BUDGET

	2002–2003 Budget	Fixed amount	Variable amount	Fixed costs
		(US$ million)		%
Programme support costs				
Country offices	44.3*	44.3*	0 *	*
Regional offices	43.4	23.0	20.4	53
Headquarters	18.7	16.8	1.9	90
Total programme support	**106.4**	**84.1**	**22.3**	
Total programme support (excluding country offices)	**62.1**	**39.8**	**22.3**	**64**
Management	41.3	38.6	2.6	94
Administration	59.2	44.9	14.3	76
Statutory requirements	3.0	3.0	0.0	100
Total PSA	**209.8**	**170.6**	**39.2**	
Total PSA (excluding country offices)	**165.5**	**126.3**	**39.2**	**76**

* Country office PSA costs were not examined under this exercise, but are considered fixed as they were set centrally using a standard configuration for all country offices.

⇨ *Variable PSA Costs*

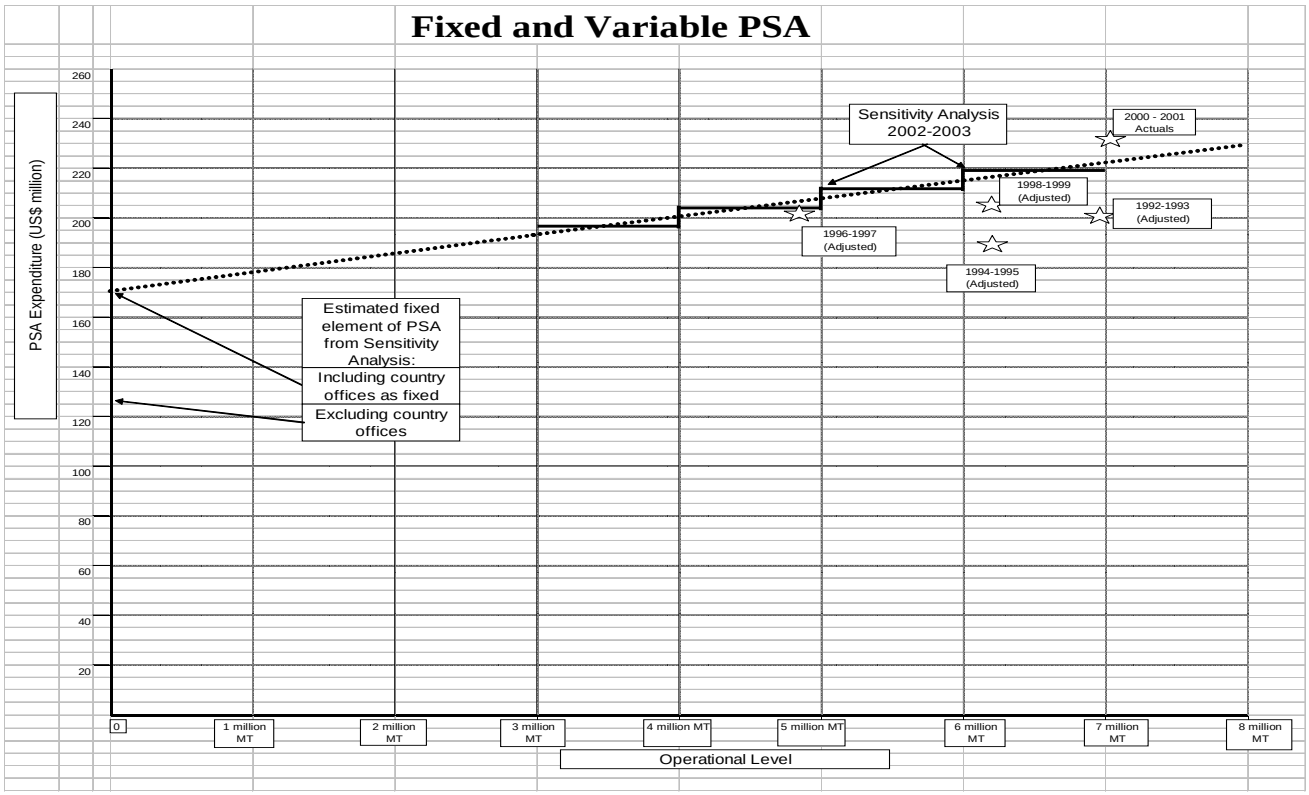
48. Table 7 indicates that, of the US$165.5 million budgeted for Headquarters and regional offices under PSA for 2002–2003, US$39.2 million could be considered variable.

49. The existence of a variable element of PSA costs means that these costs change as the operational level changes and are therefore to some extent attributable to these operations. Under the Financial Regulations, however, in order to be classified as DSC costs must have a "direct link with the provision of support to an operation". If this direct link can be established and properly identified or isolated from the present PSA level, there appears to be a strong case for the variable component of the present PSA to be reclassified as DSC and funded from these sources instead of from PSA income.

50. After the identification there is also the issue of cost attribution to projects and how the DSC funding will be used for such costs.

⇨ *Graphic Summary*

51. The results of the trend analysis and sensitivity analysis are illustrated in the following chart, which demonstrates how PSA expenditure responds to changes in the operational level.



Explanatory note: This chart illustrates the relationship between operational level (measured in terms of volume on the horizontal axis) and PSA expenditure (measured in US$ million on the vertical axis) from the data collected for this paper. The data represented is from the sensitivity analysis of the 2002–2003 PSA budget (shown as lines on the graph) and adjusted actual PSA for the biennia from 1996 to 2001 from Table 5 (shown as stars on the graph).

Conclusion 5

There is some variation in PSA expenditure requirements as a result of changes to the level of WFP operations. However, a large portion of PSA requirements does not vary when the operational level changes from one operational band to another and can therefore be considered fixed expenditure.

Conclusion 6

For the 2002–2003 PSA budget:

- approximately three quarters will not vary as a result of changes to the operational level and can be considered fixed; and
- approximately one quarter will vary as a result of changes to the operational level and can be considered variable.

Conclusion 7

PSA expenditures are funded mainly from ISC recoveries, which vary directly with tonnage changes (see Section 3). Consequently, when there is a change in the operational volume the implications for PSA income do not match the implications for PSA expenditure. The variation in PSA expenditure as a result of changes to the operational level is likely to be approximately one quarter the size of the variation in ISC income and consequently PSA income.

Conclusion 8

If a "direct link with the provision of support to an operation" can be established for the variable element of PSA, estimated at US$39.2 million for the 2002–2003 budget, there is a strong case for these costs to be reclassified as DSC with appropriate attribution of these costs to projects and allocation for various uses.

D. Recommendation

52. That PSA costs which vary with the level of operations, and can be directly linked to the support of an operation, be reclassified to DSC to make the PSA more fixed in nature. The Executive Director will set up a system of attributing these costs to projects and allocating the funds for various uses.

SECTION 5: FINAL REVIEW OF SINGLE ISC RATE

A. Introduction

53. This section further examines the current mechanism of ISC funding and the implications of the PSA gap on the single ISC rate.

B. PSA Gap: Recent Biennia (1996–2001)

54. An examination of the financial statements for 1996 to 2001 identifies the following PSA gaps:

TABLE 8: CUMULATIVE GAP BETWEEN PSA INCOME AND EXPENDITURE FOR 1996–2001 (US$ million)

	1996–1997	1998–1999	2000–2001	Cumulative 1996–2001
ISC income	178.0	215.7	188.5	
Total income from other sources	4.5	6.8	7.3	
Total PSA income	**182.5**	**222.5**	**195.8**	
PSA actual expenditure	226.2	230.8	235.9	
PSA gap (shortfall)	**(43.7)**	**(8.3)**	**(40.1)**	**(92.1)**

55. Table 8 shows that there has been a PSA shortfall over the last three biennia, which has accumulated to US$92.1 million. Before interpreting this information, the causes of the shortfall must be examined. Table 9 shows the causes of these gaps.

TABLE 9: GAP ANALYSIS FOR 1996–2001 (US$ million)

	1996–1997	1998–1999	2000–2001	Cumulative 1996–2001
PSA shortfall per financial statements	**–43.7**	**–8.3**	**–40.1**	**–92.1**
A. Accounting convention differences				
Income difference due to accounting conventions (cash versus accrual)	1.5	–7.6	40.1	34.0
PSA gap restated using accrual concept for income recognition – shortfall	**–42.2**	**–15.9**	**0.0**	**–58.1**
B. Price difference				
ISC income not realized due to lower direct cost prices	32.1	33.0	24.2	89.3
C. Volume difference				
Additional ISC income realized due to increase in volume	24.2	–74.4	–60.7	–110.9
D. PSA other income difference				
Additional other income realized	–4.5	–6.8	–5.3	–16.6
E. Difference due to increased PSA expenditure				
Additional (reduced) PSA expenditure: budgeted and incurred	–3.8	16.8	41.9	54.9
F. Difference due to programme category mix				
(Additional)/reduced ISC income due to different ISC rates for programme categories	–5.8	47.5	0.0	41.7
Rounding difference	0.0	–0.2	–0.1	–0.3
Total	**0.0**	**0.0**	**0.0**	**0.0**

Note: The only difference between this and Table 2 is the addition of the (F) programme category mix difference, which arises because different ISC rates were used for each programme category prior to 2000–2001.

56. From Table 9, the following observations are made:

- **The PSA shortfall per financial statements** for the three biennia was US$92.1 million. These shortfalls were all funded from the interest income earned in each biennium.
- **Accounting convention differences:** a considerable portion of this PSA shortfall, US$34.0 million,was due to accounting conventions. The application of an accrual policy of income recognition that would match income and expenditure would eliminate this as a cause of such gaps.
- If the **accounting convention differences** were removed, the PSA shortfall would have been reduced to US$58.1 million. This represents almost 8 percent of PSA expenditure for the three biennia, which was not funded from ISC or other income for PSA.
- **Price and volume differences:** price differences over the period meant that budgeted ISC income of US$89.3 million was not received, while volume differences meant that unbudgeted ISC income of US$110.9 million was received. In each of the three biennia, the price difference contributed towards the shortfall. In two of the biennia it was compensated for by the increased volume. In the 1996–1997 biennium, the biennium with the largest shortfall, price and volume differences *both* contributed towards the shortfall.
- **Unbudgeted other income for PSA** of US$16.6 million was received over the period as a result of the difficulties in predicting and budgeting this source of PSA income (GCCC and the cancellation of prior period obligations).
- **Increased PSA expenditure** of US$54.9 million was incurred over the three biennia. This happened because PSA budgets were revised upwards in 1998–1999 and 2000-2001 as a result of higher than expected levels of operation.
- **Programme category mix difference:** prior to 2000, the use of different ISC rates for each programme category meant that budgeted ISC income was based on a mix of direct expenditure between programme categories. If the actual mix of direct expenditure was different from budget, ISC income was affected. For 1998–1999 in particular, this resulted in a US$47.5 million difference between budgeted and actual ISC income. The implementation of the single ISC rate removed this type of difference.

Conclusion 9

Even after adjusting for accounting convention differences, there has been a significant PSA shortfall of US$58.1 million in the 1996–2001 biennia. This represents 8 percent of PSA expenditure for the period. This implies that ISC rates have not been set at a level sufficient to ensure full cost recovery. These shortfalls have been funded from interest income.

Conclusion 10

During these three biennia, one of the main contributors to this shortfall was the effect of price differences. In two of the biennia, this effect was compensated for by increased volume. The largest shortfall occurred in 1996–1997, however, with the effect of lower than budgeted volume combining with the price difference. As WFP strives to reduce the prices it pays for direct inputs, it reduces its ability to cover its ISC needs in the absence of a volume change.

Conclusion 11

The other major unforeseen contributor to the shortfall over the three biennia was the unpredictable nature of the mix of programme category expenditure. When this is combined with the use of different ISC rates for each programme category, it added an additional unknown to the ISC planning process, making ISC income even more unpredictable.

C. PSA Gap: Past Biennium (2000–2001)

57. An analysis of the PSA gap for 2000–2001 from Table 9 indicates that after adjusting for accounting convention differences, the gap would be zero.

58. This masks the compensating effect of other variables, however:

- Because of a higher than expected level of operations, additional PSA expenditure of US$41.9 million was sanctioned and incurred during 2000–2001 (additional PSA expenditure difference).
- The higher than budgeted level of operations also resulted in an additional US$60.7 million of ISC income (volume difference).
- Budgeted ISC income of US$24.2 million was not realized because actual direct cost prices were lower than budgeted (price difference).
- Unexpected additional other income for PSA of US$5.3 million was realized during the biennia.

59. This means that if there had been no increase in volume and consequently no extra PSA expenditure, the price difference would have given rise to a substantial PSA shortfall.

60. The implications of price differences on the current ISC rate therefore needs further examination.

Conclusion 12

Adjusting the PSA shortfall for the accounting convention difference based on an exact matching of income and expenditure for the 2000–2001 biennium would result in a zero gap.

Conclusion 13

This has masked significant differences resulting from volume, price and unforeseen PSA income and expenditure, however, which had a compensating effect on the aggregate PSA gap. If there had been no volume increase, the price difference resulting from lower than expected direct costs per mt would have caused a significant PSA shortfall.

D. Implications of Price Differences

61. As explained above, the prices of direct inputs measured by average direct cost per mt, have had a significant effect on ISC income.

62. Table 10 shows actual and budgeted average direct cost per mt.

TABLE 10: DIRECT EXPENDITURE PER MT

	Actual 1996–1997	Actual 1998–999	Actual 2000–2001	Budget 2002–2003
Direct expenditure (US$ million)	2 135	2 664	2 931	2 664
Tonnage (million mt)	4.916	6.182	7.031	5.471
Direct expenditure per mt—actual (US$)	**434**	**431**	**417**	**N/A**
Direct expenditure per mt—budgeted (original PSA budget) (US$)	**505**	**509**	**477**	**487**
Budget/actual difference (%)	-14	-15	-13	N/A

Note: The detailed calculation for this is contained in Annex II.

63. In 2000–2001, the actual direct costs per mt of US$417 were 13 percent lower than the budgeted US$477, causing ISC income to be US$24.2 million less than expected. Over the last three biennia, actual ISC income was US$89.3 million lower than budget because of these differences. (Table 9)

64. Table 10 outlines a declining trend in actual direct costs per mt since 1996–1997. Although budgeted figures are also declining, a significant difference remains between actual costs and budgeted costs per mt. These differences are due to the uncertain nature of these costs, which is described in Section 3.B.

65. It should be noted that this downward trend in direct input prices could be due in part to increased efficiency within WFP. If this is the case, such efficiency has a negative impact on the amount of ISC income available.

Conclusion 14

The price differences over recent biennia are attributable to declining average direct costs per mt, resulting in actual direct costs per mt being lower than the corresponding budget figures. This difference could be due to increased efficiency within WFP, or the unpredictable nature of direct costs resulting in overestimation of budget prices.

E. PSA Gap: Current Biennium (2002–2003)

66. The current approved biennial PSA budget shows a zero PSA gap based on average direct costs per mt of US$487. The downward trend in average direct costs per mt has been highlighted above. The following sections examine the implications if average direct costs per mt were to stabilize at their 2000–2001 level of US$417.

⇨ *Implications of Possible Price Difference at 7.8 Percent ISC Rate*

67. **Scenario A:** Table 11 presents the possible implications of the trend in direct input prices on budgeted 2002–2003 ISC income by assuming that direct costs per mt stabilize at an average of US$417 per mt.

TABLE 11: POSSIBLE PRICE DIFFERENCE FOR 2002–2003

	Approved budget 2002–2003	Scenario A
PSA budget—expenditure (US$ million)	210	210
Budgeted ISC income (US$ million)	208	208
Budgeted other income for PSA (US$ million)	2	2
Average direct cost per mt (US$)	487	417
Tonnage (in million mt)	5.471	5.471
Direct expenditure (US$ million)	2 664	2 281
ISC rate (%)	7.8	7.8
ISC income (US$ million)	**208**	**178**
PSA gap—shortfall (US$ million)	**0**	**30**
ISC rate needed to generate US$208 million (%)		9.1

Scenario A: These figures were calculated based on the approved 2002–2003 budget revised to assume direct costs of US$417 per mt, that is no change from 2000–2001 average prices.

68. Scenario A indicates that if direct costs per mt are assumed to stabilize at US$417 per mt and all other factors, including the ISC rate, remained as budgeted, there would be a PSA shortfall of **US$30 million**. An ISC rate of 9.1 percent would be needed to generate the ISC income necessary to eliminate this shortfall.

⇨ *Implications of Possible Price Difference at 7.0 Percent ISC Rate*

69. Under the same direct input price conditions, two other scenarios were examined:

- **Scenario B:** the ISC rate is reduced to 7.0 percent effective 1 January 2003, but PSA expenditure remains at budgeted levels.
- **Scenario C:** the ISC rate is reduced to 7.0 percent and PSA expenditure is reduced by 10 percent from 1 January 2003.

TABLE 12: EFFECT OF 7.0 PERCENT ISC RATE FOR 2002–2003

	Approved budget 2002–2003	Scenario B	Scenario C
PSA budget—original expenditure budget (US$ million)	210	210	199.5
Budgeted ISC income (US$ million)	208	208	208
Budgeted other income for PSA (US$ million)	2	2	2
Average direct cost per mt (US$)	487	417	417
Tonnage (in million mt)	5.471	5.471	5.471
Direct expenditure (US$ million)	2 664	2 281	2 281
ISC rate—2002 (%)	7.8	7.8	7.8
ISC rate—2003 (%)	7.8	7.0	7.0
Estimated revised ISC income (US$ million)	**208**	**169**	**169**
PSA gap—shortfall (US$ million)*	**0**	**39**	**28.5**

Scenario B: These figures were calculated based on the approved 2002–2003 budget revised to assume direct costs of US$417 per mt and an ISC rate of 7.0 percent from 1 January 2003.
Scenario C: These figures also include a reduction in PSA expenditure of 10 percent from 1 January 2003.
*If the effective date of the reduction to the ISC Rate were 1 January 2002 instead of 1 January 2003, the PSA shortfall could be expected to increase by US$9 million.

70. Scenario B shows that if direct input prices remain at 2000–2001 levels and the ISC rate is revised to 7.0 percent effective from 1 January 2003, with all other factors remaining as budgeted, a PSA shortfall of **US$39 million** would occur.

71. Scenario C shows a potential shortfall of **US$28.5 million** under the same conditions as scenario B updated for a 10 percent reduction in PSA expenditure from 1 January 2003.

⇨ *Implications of Possible Volume Difference*

72. The above scenarios have assumed that tonnage remains at the approved budgeted level of 5.471 million mt. Table 13 indicates the tonnage that would be necessary to compensate for each of these shortfalls.

TABLE 13: VOLUME INCREASE NECESSARY TO COMPENSATE

	Scenario A1	Scenario B1	Scenario C1
Possible shortfall (US$ million)	30	39	28.5
ISC rate used—2002 (%)	7.8	7.8	7.8
ISC rate used—2003 (%)	7.8	7.0	7.0
Additional direct expenditure required (US$ million)	384.6	527.0	385.1
Average direct cost US$ per mt	487	417	417
Additional tonnage required for zero shortfall (in million mt)	0.789	1.263	0.924
Revised tonnage required (in million mt)	**6.260**	**6.734**	**6.395**
Revised PSA shortfall (US$)	0	0	0

Conclusion 15

Assuming that all other factors remained as budgeted and that average direct costs per mt were to stabilize at 2000–2001 levels:

Scenario A: At the current ISC rate, ISC income would be US$30 million lower than budgeted for the 2002–2003 biennium. To fund this, an ISC rate of 9.1 percent would be required.

Scenario B: If the ISC rate were reduced to 7.0 percent, effective from 1 January 2003, a PSA shortfall of approximately US$39 million would result.

Scenario C: If the ISC rate were reduced to 7.0 percent and PSA expenditure were reduced by 10 percent from 1 January 2003, a PSA shortfall of US$28.5 million could be expected.

Conclusion 16

In these cases the following volume increases from the budgeted level of 5.471 million mt would be required to give a zero shortfall:

Scenario A1: An increase of 789,000 mt, to a total of 6.26 million mt.

Scenario B1: An increase of 1.263 million mt, to a total of 6.734 million mt.

Scenario C1: An increase of 924,000 mt, to a total of 6.395 million mt.

F. Executive Director's Decision

73. The Executive Director has decided to revise the remaining PSA budget downwards by 10 percent from 1 January 2003.

G. Recommendation

74. Given the cumulative PSA shortfall over the last three biennia, of US$58.1 million after adjusting for accounting convention differences, the uncertainty over direct input prices and the possible consequences if they remain lower than budgeted levels, it is recommended that the ISC rate be changed to 7.0 percent for 2003, taking note of the fact that, combined with a reduction in PSA expenditure of 10 percent from 1 January 2003, this may result in a PSA shortfall of US$28.5 million if direct input prices stabilize at their 2000–2001 levels.

75. This potential shortfall should be addressed at least partially by the reclassification of the variable elements of PSA expenditure that can be directly linked to an operation as outlined in Section 4 above.

SECTION 6: MANAGEMENT OF PSA GAPS

A. Introduction

76. Regardless of what ISC rate is set by the Board under the current system, there will almost certainly always be a PSA gap. There is therefore a need to have a clear policy on how to manage these gaps.

B. Equalization Account

77. The PSA gap is of critical importance to WFP, its donors and the Board. The current practice whereby the gap is absorbed into the General Fund does not facilitate the easy monitoring of the cumulative effect of PSA gaps across biennia. Such monitoring is fundamental to the setting of the ISC rate.

78. Setting up an equalization account to record all PSA gaps (i.e. the effect of all PSA expenditures and all income applied to fund such expenditures) would facilitate the ongoing examination of this crucial indicator in an easier, more transparent manner. Such an account would record the cumulative PSA surplus or shortfall from one biennium to the next.

79. Annual or biennial analysis of the movements on this account into its components, such as price differences and volume differences, would improve transparency and highlight the

factors that should influence the setting of the ISC rate and the decisions to be made regarding the shortfall or surplus.

80. The introduction of a PSA equalization account would also highlight the accumulated PSA gap brought forward from previous biennia.

Conclusion 17

A PSA gap equalization account to record PSA gaps and a procedure to analyse these items into such elements as price differences and volume differences would improve transparency and greatly benefit the decision-making process for setting the ISC rate.

C. PSA Shortfall—Use of Interest Income

81. The 1997 proposal to the Board on the use of interest income (WFP/EB.3/97/4-C) also highlighted the "structural imbalances between an approved PSA budget and the level of ISC recovery". It recommended that interest "earned during a current financial period should be applied to meet any structural imbalances".

82. The recent Joint Inspection Unit (JIU) report on Support Costs Related to Extrabudgetary Activities in Organizations of the United Nations System also recommends that consideration be given to the use of interest income "to reduce extrabudgetary support costs".

83. The availability of interest income at the end of a biennium to meet any PSA funding shortfall for that period would help improve the ISC planning process. It would also reduce the risks associated with lowering the ISC rate, because there would be a mechanism in place to address any resulting PSA shortfalls.

84. This is only one mechanism, however, and it will work only when sufficient amounts of interest are generated to cover the shortfall.

Conclusion 18

A PSA shortfall must be funded. The only mechanism available at the present time to fund such gaps is the use of interest income, which should be formalized.

D. PSA Surplus

85. In cases where there is an accumulated surplus after a given lapse of time, that is where PSA income is greater than PSA expenditure, a number of options have been identified. The surplus could be used as follows:

- to fund the PSA expenditure of the next biennium;
- to reduce the ISC rate for later biennia;
- to refund donors, although this may require extensive administrative work; or
- to be reprogrammed to projects or the Immediate Response Account.

E. Executive Director's Decision

86. The Executive Director has decided to establish a PSA equalization account and a formal procedure to analyse and report movements in such an account to the Board, to assist in the annual review of the ISC rate.

F. Recommendations

87. It is recommended that interest income earned during a period should be made available to meet PSA shortfalls arising as a result of structural imbalances. At the same time, other mechanisms should be established to address future situations where interest income may not be sufficient to cover these shortfalls.

88. It is recommended that, in the case of PSA surpluses, the ISC rate should be reduced to zero out such an equalization account.

SECTION 7: OTHER FUNDING OPTIONS FOR PSA

A. Introduction

89. The above discussion on PSA expenditure illustrates its relatively fixed nature in relation to the level of operational activity. This makes it reasonably straightforward to forecast.

90. Conversely, PSA income – composed mainly of ISC recoveries—varies directly with operational activity and is also significantly influenced by the prices of direct inputs. Both of these factors make the PSA income level extremely unpredictable.

91. The following sections examine alternative PSA funding options to address this uncertainty.

B. Funding Options Presented by Working Group in 1998

92. The Report of the Formal Working Group on R&LTF considered three options to identify alternative approaches to the classification of costs between DOC, DSC and ISC. These three options considered primarily the treatment of country office and regional office costs.

93. The following sections revisit and update these options for the 2000–2001 and 2002-2003 biennia. Annex VI provides additional detail.

⇨ *Option 1: Country Office PSA Based on Tonnage Bands*

94. This option would use the PSA budget to fund a “core staffing and operational structure, based on the tonnage throughput of each (country) office”.

95. The application of the staffing levels, non-staff costs and tonnage bands used by the working group would result in an additional country office PSA requirement of US$55.3 million for 2002–2003—an increase of 26 percent of the total PSA budget. This would require a corresponding increase in the ISC rate, bringing it up to over 9.6 percent.

96. A revised option 1, classifying country offices using alternative tonnage bands and alternative core staffing and operational structures, was also examined. This would require an increase in the 2002–2003 PSA budget of 7 percent and an increase to the ISC rate of approximately 0.5 percent.

97. These options provide a certain level of continuity in essential support functions of country offices, while providing the necessary flexibility to use PSA to reinforce country offices where necessary. An ISC rate higher than the current rate would be required, however.

⇨ *Option 2: Reclassifying Additional Costs from PSA to DSC*

98. This option examined the possibility of moving additional costs from PSA to DSC, resulting in a reduction in PSA costs and consequently the ISC rate.

99. Various alternatives for moving additional costs to DSC have been identified. The theoretical effects of this have been updated and can be summarized as follows:

TABLE 14: SUMMARY OF WORKING GROUP OPTION 2—UPDATED

	Estimated ISC rate 2000–2001 (%)	Estimated ISC rate 2002–2003 (%)
Transferring all country office costs to DSC	5.5	6.2
Transferring all regional bureau costs to DSC	6.8	6.4
Transferring all country office, regional bureau and cluster office costs to DSC	4.5	4.6
Transferring all country office, regional bureau, cluster office and Headquarters programme support costs to DSC	3.1	3.9

100. This option was considered by the working group to be more forward thinking; it would ensure that PSA costs were of a more indirect nature, while establishing a substantially lower ISC rate.

101. It also increases the risk, however, because it increases the amount of fixed costs funded by DSC, which is a variable funding source under the existing R&LTF policies.

⇨ *Option 3: Current Option*

102. This is the current option, which, starting in 2000–2001, transferred 25 percent of country office PSA costs to DSC and introduced the 7.8 percent ISC rate. This option uses ISC to fund all Headquarters support costs, regional office support costs and a standard minimum country office structure considered essential for a WFP presence.

Conclusion 19

The application of the 1998 working group's option 1 (country office PSA based on tonnage bands) would still require an ISC rate of above 9.6 percent. The concepts outlined by the working group can be revised, however, using different tonnage bands and different minimum structures to give an adjusted option 1, which would require an ISC rate increase of 0.5 percent from the present rate of 7.8 percent.

The application of the 1998 working group's option 2 (reclassifying additional costs from PSA to DSC) would result in an ISC rate of between 3.9 percent and 6.2 percent for 2002-2003. This will increase risk, because additional costs, some of them fixed costs, would be funded from DSC, which is a variable source of funding.

C. ISC "Dual Rate Mechanism"

⇨ *Dual ISC Rates*

103. In the preliminary review, the concept of an incremental ISC rate was introduced. This would involve higher rates of ISC applying to initial donations in a biennium, with lower rates for subsequent donations to increase certainty in the ISC planning process and reduce the risk of PSA funding shortfalls.

104. There are alternative ways of achieving this. As outlined in the preliminary review and Section 4 above, a substantial portion of PSA expenditure is fixed in relation to the level of operational activity. A higher initial ISC rate, or primary ISC rate, could be applied to all contributions until the fixed element of PSA expenditure is funded. After that point, a secondary ISC rate could be applied to cover the variable element of PSA expenditure.

⇨ *Primary ISC Rate*

105. The higher primary ISC rate should be sufficient to generate enough ISC income to ensure PSA expenditure is funded—after allowing for other income for PSA—at a "minimum level of expected activity" for the biennium.

106. The minimum level of expected activity in this model should be a conservative estimate, because the consequences for ISC income if it is not reached are much greater than under the current model.

107. The potential impact of four different minimum levels of expected activity on the primary ISC rate is presented in Table 15.

TABLE 15: IMPACT OF MINIMUM LEVELS ON PRIMARY ISC RATE

	Minimum level of expected activity per biennium			
	3 million mt	**4 million mt**	**5 million mt**	**6 million mt**
Expected PSA expenditure (US$ million)	192	201	207	215
Less: expected PSA other income (US$ million)	2	2	2	2
ISC income required (US$ million)	190	199	205	213
Direct cost per mt* (US$)	417	417	417	417
Primary ISC rate required assuming 2000–2001 direct prices (%)	**15.3**	**12.0**	**9.8**	**8.5**

*Assumed to remain at 2000–2001 levels: see Section 5D.

⇨ *Secondary ISC Rate*

108. Once the minimum level of operational activity has been reached, the lower secondary ISC rate would be applied. This would only need to be enough to cover the variable element of PSA expenditure and could be calculated as shown in Table 16.

TABLE 16: ISC SECONDARY RATE

PSA requirements from sensitivity analysis	
6–7 million mt (US$ million)	218
5–6 million mt—approved 2002–2003 budget (US$ million)	210
4–5 million mt (US$ million)	203
Up to 4 million tons (US$ million)	195
Average PSA requirement change per 1 million mt change [(A)] (US$ million)	7.7
Average direct cost per mt* (US$)	417
Average direct cost per 1 million mt[(B)] (US$ million)	417
ISC secondary rate required [(A divided by B)] based on sensitivity analysis and assuming 2000–2001 direct prices (%)	**1.8**

*Assumed to remain at 2000–2001 levels: see Section 5D.

109. The above calculations are based on the current approved PSA budget for 2002–2003. The proposal to reclassify variable PSA expenditures that can be directly linked to an operation to DSC would reduce the incremental rate accordingly.

⇨ *Trigger Points for Incremental Rate*

110. Any trigger point for the secondary ISC rate should be simple, transparent and equitable to all donors, but should not discourage or delay contributions. Such trigger points are difficult to identify.

111. One option is to trigger the secondary ISC rate when each donor surpasses a donation level that would ensure the organizational minimum level of expected activity is achieved. This could be done on the basis of:

a) contribution forecasts: when donors exceed their contribution forecast for a biennium, the secondary rate would be applied; or

b) past contributions: when donors exceed a contribution level based on previous years' contributions, the secondary rate would be applied.

112. Alternatively, the primary ISC rate could be applied to all contributions until the required level of income is achieved. This may act as a disincentive to donating early in a biennium, however.

⇨ *Other Alternatives*

113. It should be noted that the above model represents only one of many alternatives. Other models, for example resulting in lower primary rates and higher secondary rates, are also possible.

114. Incremental support cost recovery rates are used extensively by the other United Nations organizations studied for the comparative study. They are examined in detail in a recent JIU report entitled Support Costs Related to Extrabudgetary Activities of the United Nations System. The use of such an approach by these organizations involves an amount of cross-subsidization of one type of funding by another. One of the United Nations organizations examined in the comparative study intends to discontinue this practice.

115. The experience of these organizations should be considered when reviewing any proposal to implement incremental ISC rates at WFP.

Conclusion 20

An ISC dual rate mechanism would reduce the uncertainty over ISC income if it could generate higher levels of ISC by using a primary rate of ISC towards the beginning of the biennium followed by lower amounts subsequently by using a secondary rate of ISC. There are many different ways whereby this could be achieved, one of which is outlined above.

The implementation of such an approach would have a fundamental effect on WFP's relationship with its donors. It would require the identification of equitable trigger points and goes against the experience of other United Nations organizations using incremental rates.

D. Government Counterpart Cash Contributions to Local Operating Costs (GCCC)

⇨ *Introduction*

116. Another current source of funding for PSA are the host government counterpart cash contributions for local operating costs (GCCC). At present, relatively little income is generated from this source of funding: for the 2000–2001 biennium, the US$3 million received represented only 1.3 percent of PSA expenditure. There are many issues which make GCCC unique and which need further examination.

⇨ *Financial Regulations*

117. WFPs Financial Regulations (FR 4.7) provide that governments of recipient countries are expected to contribute a substantial portion of the costs of WFP country offices, in kind and in cash. The extent of this contribution shall be set out in an agreement between WFP and the government concerned. On the recommendation of the Executive Director, the Board may exempt specific countries from this regulation.

118. Implementing these provisions of the Financial Regulations has been difficult. Many of the country offices that were closed towards the end of 1997 were those that could have afforded to pay cash contributions for the cost of the country offices. Many of the remaining country offices that are expected to pay have financial difficulties in meeting these cash obligations. On the other hand, some of them provide in-kind contributions towards local operating costs, such as free office buildings and premises and other free services to the WFP country offices. Under existing accounting practices, these in-kind contributions are not accounted for in the books of account and therefore are not reflected as GCCC. This presents a dilemma, because if WFP decides to put a valuation on these in-kind contributions and record them as both PSA income and expenditures, then the PSA levels will increase accordingly.

⇨ *Income Recognition*

119. The other issue relating to these contributions is the accounting policy on income recognition. At the present time, these are recorded as income only when actually received, following the cash basis of accounting for income. Should there be a change in the accounting policy, however, as discussed in Section 3, then WFP has to decide on the appropriate way of accruing this income from governments of recipient countries. Accruing and recording these as receivables may result in the accumulation of receivables

which cannot be collected because of difficulties experienced by these governments in meeting these financial obligations.

⇨ *GCCC Agreements*

120. The formulation of basic agreements with host governments to include a provision setting out these obligations has been a slow process. The inclusion of provisions in regard to GCCC in new agreements or revised agreements has proved difficult to negotiate. In 2001, when seven agreements were piloted, there was not much success achieved, as the external auditor points out in the 2000–2001 audit report. Only two have been successfully negotiated to date, two are being negotiated and the rest showed no progress.

121. Recently, some countries wanting to meet their financial commitments have endeavoured to find alternative ways of meeting their obligations. One country paid directly to WFP but requested that the funds should be used directly to pay for the rent of the office premises being occupied by the WFP country office instead of being recorded under PSA income in the General Fund. The amount remitted was nevertheless higher than the US$55,000 allocation for non-staff costs set for all country offices under the R&LTF. Another country office deposited a sum of money in a trust fund and agreed that only interest generated from these funds be remitted to WFP as its cash contributions. This modality of payment provides some kind of assurance of an annual remittance of GCCC by this particular country.

⇨ *R&LTF Review*

122. In view of the above complexities and the unique nature of GCCC, it is therefore recommended that the issues of collecting, accounting and recording GCCC as part of PSA income be included in the review of the R&LTF. This review should also include an examination of the provisions of the Financial Regulations and how they can be realistically implemented, given the situation of these host governments.

Conclusion 21

GCCC has not been a significant source of PSA income because of difficulties encountered by countries in meeting the obligation and difficulties in concluding agreements with host governments.

In-kind contributions by host governments are not at present accounted for. Contributions in cash are recorded as income only upon actual receipt.

E. Recommendations

123. It is recommended that the upcoming review of WFP's resources and long-term financing policies should examine more closely PSA funding for country offices and the collection, recording and accounting of GCCC.

SECTION 8: APPROPRIATE LEVEL OF PSA

A. Introduction

124. Determining an appropriate level of PSA is a difficult task, because it requires a balance between the following two opposing pressures:

a) the need to spend as high a proportion as possible of WFP's income on direct implementation of the food aid programmes, projects and activities that are its purpose; and

b) the need to provide an organizational structure that supports efficient and effective implementation of these programmes and projects. This structure is required to provide:

   i) organizational governance, policy direction and inter-governmental and inter-agency coordination;

   ii) strategic direction and effective operational management for the Programme;

   iii) sound organizational planning and policy making;

   iv) infrastructure, including

      ◊ the administrative, financial and personnel infrastructure required to run the organization effectively on an ongoing basis; and

      ◊ infrastructure to ensure that the advocacy, knowledge base, communication and assessment capacity of the Programme are maximized;

   v) accountability and control within WFP; and

   vi) the capacity to respond quickly in an emergency, which has a fundamental bearing on the success of an operation and also reduces costs in the long run.

125. Care must be taken to strike the right balance between these two forces, maximizing the direct utilization of resources while ensuring that the institutional capacity of WFP is sufficient to ensure that such utilization contributes towards achieving the long-term goals of the Programme.

126. The requirement for such a balance, combined with the differing natures of PSA expenditure and PSA income, indicates that the PSA budget should not be based only on considerations such as tonnage or a percentage of expected direct costs. In particular, the need for an organizational structure shows that additional factors should be considered in the formulation of the PSA budget for the Programme.

B. Cost-Effectiveness

127. A comparative study was undertaken to identify how WFP compares with other United Nations organizations in terms of its indirect support **costs**. The results of this are outlined in Section 9.

128. Any discussion on the cost-**effectiveness** of PSA, however, must consider not only cost but also effectiveness. Effectiveness can be considered as the ability to achieve desired results, in this case contribute towards fulfilling the mandate of the Programme. The comparative study concentrates on cost because it more measurable, but this shows only one side of the equation.

129. Apart from comparative analysis, other techniques exist for WFP to establish PSA cost effectiveness internally:

- A complete review of the PSA budget using a zero-based approach could be used to identify the most appropriate level of PSA infrastructure needed for WFP's operations. Now is the most opportune time to do this because of the recent major changes in the organization such as decentralization and the implementation of WINGS. These changes evidently require a thorough review of the present PSA budget, which has been prepared for the previous organizational set-up.

- The establishment of a results-measurement framework for PSA-funded activities would link PSA expenditure to results and provide information on PSA effectiveness.

Conclusion 22

Although a comparison of ISC has been undertaken with other United Nations organizations, any discussion of the effectiveness of WFP, or its effectiveness in comparison with other organizations, would involve a comprehensive analysis and comparison of the results of each of the organizations, and how these results advanced the organizational mandates.

At the conclusion of the comparative study, some of the United Nations organizations studied expressed their concern that studies of this nature should be conducted jointly with them.

Conclusion 23

Because of the different natures of PSA income and PSA expenditure, the PSA budget should not be based only on considerations such as tonnage or a percentage of expected direct costs. The need for an adequate organizational structure shows that additional factors should be considered in the formulation of the PSA budget.

Conclusion 24

A zero-based approach to the PSA budget-setting exercise of 2004–2005 would help determine the most appropriate level of PSA infrastructure for WFP's operations.

Conclusion 25

The establishment of a results-measurement framework for PSA-funded activities would also provide additional information on PSA cost-effectiveness.

C. Executive Director's Decision

130. The Executive Director has decided to prepare the 2004–2005 PSA budget using a zero-based approach with a view to setting an appropriate level of PSA.

D. Recommendations

131. To reflect the nature of PSA expenditure and PSA income more accurately, PSA budgets should not be based solely on considerations such as tonnage or a percentage of expected direct costs. It is recommended that a zero-based approach to the PSA budget-setting exercise of 2004–2005 should be adopted to help determine the most appropriate level of PSA infrastructure for WFP's operations.

132. It is further recommended that a results-measurement framework for PSA-funded activities be examined as part of the upcoming review of R&LTF to provide additional information on PSA cost-effectiveness.

SECTION 9: COMPARATIVE STUDY OF UNITED NATIONS AND NON-GOVERNMENTAL ORGANIZATIONS

A. Introduction

133. The Executive Board of WFP requested the Secretariat to embark on a comparative study of the support budgets of comparable NGOs and United Nations organizations.

B. Non-Governmental Organizations

134. The study of NGOs will examine what makes WFP different from NGOs and will involve a three-month comparison study, the results of which will support the preparation of a paper to be presented to the Board in February 2003.

⇨ *NGO Study Scope*

135. Using a combination of desk reviews, case studies and field visits, the NGO study will compare WFP to comparable NGOs, focusing on three main areas:

a) Mandates:

i) to compare WFP's mandate to those of the NGOs;

ii) to examine how differences and similarities in mandates might affect indirect and direct support costs in WFP and the NGOs; and

iii) to examine how different mandates require different organizational structures, and how these may impact support costs.

b) Case Studies:

(i) to compare interventions by WFP and NGOs in and between three countries, covering emergency operations (EMOPs), protracted relief and recovery operations (PRROs) and development; and

(ii) to examine business processes in WFP and the NGOs such as shipping, procurement, storage and assessment.

c) Cost Comparison:

(i) to review relevant work on cost comparisons between WFP and NGOs;

(ii) to compare support costs for WFP and selected international NGOs, as derived from published annual reports and other sources;

(iii) to compare WFP and NGO cost structures; and

(iv) to review the sources of funding for WFP and the NGOs.

C. United Nations Organizations

136. The Secretariat conducted a unilateral study of the treatment of support costs in the United Nations Development Programme (UNDP), the United Nations Population Fund (UNFPA), the United Nations Children's Fund (UNICEF), the Office of the United Nations High Commissioner for Refugees (UNHCR) and WFP.

137. This study was performed through a review of public documents and in-depth interviews with the staff of the organizations concerned. It was carried out by a number of WFP professionals led by a consultant with extensive professional experience both in and outside the United Nations system.

138. The results and conclusions of this study are outlined in the following paragraphs, which follow the structure of the study, which is attached as Annex VII.

⇨ *Organizational Mandates, Strategies, Activities and Sizes:*

139. A review of the organizations' mandates strategies, activities and sizes revealed the following:

a) The organizations have very different objectives, strategies and mandates. This requires the use of a variety of direct inputs to achieve the diverse results of the organizations.

b) The choice of implementation modality used by each organization varies from almost full direct implementation to almost no direct implementation.

c) In terms of expenditure, the organizations differ significantly in size: the largest is over ten times the size of the smallest.

d) The varied nature of the results being achieved by the organizations reduces the validity of comparing the inputs, including the support costs.

140. The resulting fundamental differences in the mandates, strategies, activities, sizes and outputs of the organizations *require* different levels of management and support. The support costs will therefore of necessity be different across the organizations. This reduces comparability.

⇨ *Organizational Structure*

141. The organizations are similar in structure; the decentralized nature of WFP and UNICEF regional offices are the main exception. Geographical coverage varies considerably, as indicated by the following country office numbers:

TABLE 17: COUNTRY OFFICE COVERAGE

	Number of country offices
WFP	83
UNICEF	126
UNDP	136
UNFPA	110
UNHCR	123

⇨ *Budgetary Practices*

142. The budgetary practices in place in each of the organizations have similarities, particularly in terms of their support budgets.

143. With the exception of UNHCR, the organizations currently prepare their support budgets on a biennial basis. All the organizations apply the harmonized definitions to their support budgets, however, classifying costs into:

- programme costs; and
- support costs, subdivided into:
  - ◊ programme support—country offices;

- ◊ programme support-headquarters; and
- ◊ management and administration.

144. In addition to these cost categories, two of the organizations studied budgeted support costs under the following categories:

- ➢ programme support—agencies: used by UNFPA for payments to other agencies for technical and administrative support; and
- ➢ support to the operational activities of the United Nations: used by UNDP for the following costs:
  - ◊ programme support to resident coordinators;
  - ◊ costs associated with the United Nations Volunteers (UNV) Special Voluntary fund; and
  - ◊ country office support, the United Nations Development Group (UNDG) offices, UNV and Inter-Agency Procurement Service offices.

⇨ *Accounting Conventions*

145. The policies on income recognition and expenditure recognition are summarized in Table 18.

TABLE 18: SUMMARY OF ACCOUNTING POLICIES

	Recognition of contribution income	Recognition of expenditure
WFP	Cash receipt basis	Accrual basis*
UNICEF	Accrual basis	Accrual basis*
UNDP	Cash Receipt basis	Accrual basis**
UNFPA	Accrual basis	Accrual basis**
UNHCR	Accrual basis	Accrual basis*

*Except staff expenditure, which is recognized on the basis of disbursements.
**Except staff and projects executed by governments and NGOs, which are accounted for on the basis of cash disbursements.

⇨ *Resourcing and Financing of Support Costs*

146. With the exception of WFP, all the organizations studied use their regular resources, or untied contributions, to fund a base level of support costs. Non-regular contributions are used to fund **incremental** support costs, not a pro-rata share of all support costs.

147. This incremental approach is similar in concept to the option of using dual ISC rates described above, where the primary ISC rate would be used to fund the fixed element of PSA expenditure and the secondary ISC rate to fund the variable element.

⇨ *Cost Categories*

148. UNICEF, UNDP, UNFPA and UNHCR classify all costs that are not included in their support budget as programme costs. They have no cost category equivalent to WFP's DSC to identify separately costs that are support in nature but directly related to a project.

149. This makes a straight comparison of total direct and indirect support costs difficult. As a result, several different methods of comparing support costs were examined; they are outlined in Annex VII.

⇨ *Budgeted Cost Analysis*

150. In order to prepare a more meaningful comparison of indirect support costs and to compare like with like, other organizations' costs were re-categorized into indirect and direct, using the methodology applied in WFP.

151. WFP charges a standard configuration of staff and non-staff costs in country offices to indirect support costs, with the rest charged to direct costs.

152. Applying this methodology to the other organizations, that is moving country office costs that exceed the WFP standard configuration to direct programme costs, would give rise to the following budgeted indirect support costs as a percentage of total budgeted costs for the two years 2002 and 2003:

TABLE 19: RECATEGORIZED COST COMPARISON (%)

	2002–2003 biennium
WFP	7.2*
UNICEF	14.0
UNDP	13.0 **
UNFPA	25.7†
UNHCR	13.1

* The use here of total as the denominator gives a different result from the WFP ISC rate (currently 7.8 percent) which uses only direct costs as the denominator.
** These support costs include 5.7 percent, which relates to the support of the operational activities of the United Nations.
† These support costs include 5.1 percent, which relates to technical and administrative support paid to other agencies.

Conclusion 26

Given the information available and the uniqueness of WFP's DSC category, the figures set out in Table 19 represent the most appropriate comparison of indirect support costs possible in the time-frame of the current study. These figures indicate that WFP's indirect support costs are lower in relation to the level of direct costs than in the other United Nations organizations studied.

SECTION 10: GENERAL CONCLUSIONS AND RECOMMENDATIONS

A. General Conclusions

⇨ *Structural Imbalances*

153. The discussions above examine recent differences between PSA income and PSA expenditure, or PSA gaps. Such gaps can currently be attributed to the following:

a) structural imbalances of ISC income, including differences due to:

   i) accounting conventions;

   ii) ISC income impacted by direct cost price differences; and

   iii) ISC income impacted by direct cost volume differences; and

b) unforeseen differences in other income for PSA and PSA expenditure.

154. The change in the accounting policy on income recognition to recognize income on an accrual basis will result in a closer matching of income and expenditure and minimize (but not totally remove) the accounting convention structural imbalances. This will allow the focus to shift to the structural imbalances caused by price and volume and the unforeseen differences in other income for PSA and PSA expenditure.

⇨ *PSA Income*

155. The remaining structural imbalances arise due to variations in direct costs. This can be due either to variations in the operational level (volume) or to variations in the prices of direct inputs (price).

156. The level of operations and the prices of operational inputs are extremely difficult to predict, given WFP's diverse operations, variable inputs and constantly changing operational priorities.

157. These price and volume uncertainties have a corresponding impact on ISC income, and consequently PSA income.

⇨ *PSA Expenditure*

158. PSA expenditure appears more stable and predictable than PSA income. The sensitivity analysis conducted on the 2002–2003 PSA budget indicates that roughly three quarters of PSA expenditure is fixed relative to changes in the level of operational activity. The remaining quarter is variable and should therefore be reclassified to DSC if it can be directly linked to operations. However, there has to be a system of attributing these costs to projects and allocating them for various uses.

⇨ *PSA Gaps*

159. The uncertainty of PSA income, and ISC income in particular, means that there will almost certainly always be a gap between PSA income and expenditure for a given period.

160. These PSA gaps, which can be either shortfalls or surpluses, are currently absorbed by the General Fund. This makes it difficult to ascertain the cumulative effect of the gaps and to determine the impact of price and volume differences from one biennium to the next.

161. The Executive Director has therefore decided to establish an equalization account to isolate the gaps and monitor their accumulation or depletion over time.

162. In the absence of such an equalization account, an analysis of the last three biennia was carried out, which indicates that a cumulative shortfall of US$58.1 million has arisen, after adjusting for accounting convention differences. This indicates that the ISC rates over this period have been insufficient to ensure full cost recovery.

163. The method of funding such shortfalls should be formalized. The formalization of the availability of an additional source of PSA income, such as interest income, is a possibility which would follow the current practice. This would improve the PSA planning process

and reduce the risk associated with reducing ISC rates. Other mechanisms should be explored, however, for situations where interest income will not be sufficient to cover the shortfall.

164. On the other hand, should there be a surplus, it could be used:

- to fund the PSA expenditure of the next biennium;
- to reduce the ISC rate for subsequent biennia;
- to refund donors, although this may require extensive administrative work; or
- to be reprogrammed to projects or the Immediate Response Account (IRA).

⇨ *Direct Input Prices*

165. The two largest unexpected factors contributing to the shortfall over the three biennia were:

a) ISC income not realized because of different programme category ISC rates; and

b) ISC income not realized because of lower-than-expected direct cost prices.

166. The introduction of the single ISC rate at the beginning of 2000 removed the first of these uncertainties.

167. The trend of reducing direct cost prices, however, resulted in ISC income being US$24.2 million lower than expected in 2000–2001. If this trend were to continue, assuming all other factors remain as budgeted:

a) if the ISC rate remains at 7.8 percent for 2002–2003, it would result in a PSA shortfall of over US$30 million. An ISC rate of 9.1 percent would be required to fund this fully;

b) if the ISC rate were changed to 7.0 percent for 2003, it would result in a PSA shortfall of US$39 million; or

c) if the ISC rate were changed to 7.0 percent for 2003 and PSA expenditure were reduced by 10 percent from 1 January 2003, it would reduce such a shortfall to US$28.5 million.

168. These potential shortfalls could be offset by an increase in volume. They may be at least partially offset by the reclassification of the variable elements of PSA expenditure to DSC that can be linked directly to an operation as outlined above.

⇨ *Comparative Study*

169. The comparison of WFP support costs with those of other United Nations organizations highlights the differing mandates strategies, sizes and implementation modalities of the organizations and the fact that these necessitate different levels of support and consequently support costs.

170. The study also highlights the differences between WFP's use of a DSC category and the harmonized format with no separate category for costs of this nature.

171. Applying WFP's costing methodology to the other organizations, the study indicates that WFP's indirect support costs levels are less than the other United Nations organizations studied.

⇨ *Appropriate Level of PSA*

172. Although the comparative study indicates comparative efficiency, **cost-effectiveness** of PSA is more complex. It is suggested that the appropriate level of PSA should be established through a zero-based approach to the PSA budget of 2004–2005 and the introduction of a results-measurement framework for PSA.

B. Main Recommendations

173. As a result of the above analyses, the Executive Director recommends that the Board:

a) **take note** of this Final ISC Review Paper and its Annexes, including the comparative study of United Nations organizations, which represent a comprehensive analysis of the Programme's ISC;

b) **take note** of the US$40.1 million shortfall in the funding of the 2000–2001 PSA actual expenditures and **approve** the use of interest income from the General Fund to fund this shortfall;

c) **take note** of the change to the accounting policy by the Executive Director, which will recognize income on an accrual basis with retroactive effect from 1 January 2002;

d) **take note** of the establishment by the Executive Director of a PSA equalization account to record any gaps between actual PSA income and PSA expenditures and decide in future how to address these gaps, including continuation of the practice of using interest income for any shortfalls;

e) **approve** the reclassification of those PSA expenditures that are variable in nature (support costs that vary with volume changes) and that can be directly linked to an operation, to make the PSA more fixed in nature (that is, to represent costs that do not vary with volume changes); the Executive Director shall set up a system of attributing these costs to projects and allocating the funds for various uses;

f) **take note** of the decision of the Executive Director to revise the remaining PSA budget downwards by 10 percent from 1 January 2003.

g) **confirm** the ISC rate of 7.8 percent for 2002;

h) **approve** the reduction of the ISC rate to 7.0 percent for 2003;

i) **look forward** to the submission by the Executive Director of the 2004–2005 PSA budget prepared using a zero-based approach with a view to setting an appropriate level of PSA; and

j) **consider** the following matters in the review of WFPs R&LTF policies:

   i) country office PSA funding;

   ii) the collection, recording and accounting of GCCC; and

   iii) results-measurement frameworks for PSA-funded activities.